COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS & ENERGY

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| Petition of Bay State Gas Company, pursuant to G.L. c. 164, § 94 and 220 C.M.R. § 6.00 et. seq., for authority to establish a Gas Cost Incentive Mechanism | } | D.T.E. 01-81 |

# DIRECT TESTIMONY OF REBECCA BACHELDER

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ALLENERGY GAS & ELECTRIC MARKETING COMPANY, L.L.C.

APRIL 5, 2002

## I. Qualifications

Q. Please state your name, affiliation and business address.

A. My name is Rebecca Bachelder. I am Director, Legislative and Regulatory Affairs for AllEnergy Gas & Electric Marketing Company, L.L.C. My business address is 95 Sawyer Road, Waltham, MA, 02453.

Q. Please describe your responsibilities at AllEnergy.

A. My primary responsibilities are to identify areas of legislative or regulatory risk and opportunity, and represent AllEnergy's positions in informal and formal meetings with Local Distribution Companies ("LDCs") or regulatory proceedings to mitigate risks and promote the development of the competitive market in the AllEnergy footprint. AllEnergy provides unregulated retail natural gas service to customers in Massachusetts and throughout the Northeast United States. I have represented AllEnergy in formal proceedings in Connecticut and Massachusetts, have participated in collaboratives in Massachusetts, Connecticut, New Hampshire and New York, and have represented AllEnergy's interests in the states of New Jersey and Rhode Island as well as the aforementioned jurisdictions.

Q. Please describe your educational and professional background.

A. I graduated Magna Cum Laude from the University of Massachusetts, Amherst in 1979 with a BBA in Finance and a minor in Economics. In 1984, I received a Master of Business Administration from Boston University. I joined AllEnergy in 1997 and have held the responsibilities of Director, Legislative and Regulatory Affairs throughout my tenure. In 1999, I was given additional responsibilities as

Director of Customer Care. In that capacity, I was responsible for back office operations. My responsibilities included maintenance of customer accounts internally and with utilities, billing, customer service, credit and collection, as well as legislative and regulatory affairs. Recently, my focus has returned to Legislative and Regulatory Affairs as the business needs have dictated. Prior to joining AllEnergy, I was employed by Boston Gas for eighteen years in a number of positions. I managed the Rates and Regulatory Group from 1988 through my departure in 1997. I have made numerous appearances before the Massachusetts Department of Telecommunications and Energy ("Department") as well as before the state public utilities commission in Connecticut. A complete list of my appearances is included as Exhibit AE – 2.

## II. Purpose of Testimony

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to present policy concerns with respect to the impact of a gas cost incentive mechanism, or GCIM, on the competitive market that the Department should consider as it decides whether or not to allow Bay State to implement its proposed GCIM.

## III. Regulatory Overview

Q. Please state your understanding of the Department's policies toward the competitive natural gas industry and incentive regulation.

A. The Department has clearly articulated its goals for a competitive natural gas industry and incentive regulation.

The Department's goals for a competitive natural gas industry are to:

(1) Provide the broadest possible customer choice;

(2) Provide all customers with an opportunity to share in the benefits of increased competition;

(3) Provide functional separation between sale of gas as a commodity and local distribution service;

(4) Support and further the goals of environmental regulation; and

(5) Rely on incentive regulation where a fully competitive market cannot exist, or does not yet exist.

D.T.E. 98-32-B (February 1, 1999), at 4.

Furthermore, in Incentive Regulation, D.P.U 94-158 ( February 21, 1995), the Department articulates criteria it will use to evaluate incentive proposals.

Incentive proposals should:

a) Be Consistent with Department Regulations, Statutes and Governing Precedent;

b) Be Consistent with Market-Based Regulation and Enhanced Competition. Incentive mechanisms must complement the ongoing movement towards a more market-based utility framework. Incentive proposals should be designed to serve as a vehicle to a more competitive environment and to improve the provision of monopoly services.

c) Safeguard System Integrity, Reliability, and Current Policy Objectives.

d) Reward Utility Performance and Address Exogenous Costs.

e) Focus on Comprehensive Results. Broad-based mechanisms appear to better complement a competitive marketplace. If a utility opts to submit a narrowly-targeted incentive proposal, the petitioner must satisfactorily address the concern that it may create perverse incentives.

f) Incorporate Well-Defined Measurable Indicators of Performance.

g) Consistent with Accounting Standards and Acceptable within the Financial Community.

*Id*., at 55-65.

The Department has also approved merchant service related incentives to maximize the use of LDC owned pipeline and storage capacity through interruptible sales, sales for resale and capacity release. Incentives for LDCs to release underutilized capacity resulted in the availability of more capacity to the competitive market. This incentive has enhanced competition by increasing the liquidity of the capacity market. It complies with the criteria set forth by the Department.

Q. What competitive energy market initiatives has the Department been working on more recently?

A. In the Spring of 2001, the Department sought comments from electric market participants as to actions the Department could take to expand the range of competitive options available to consumers and invited participants to a one-day conference on May 31, 2001. Subsequently, the Department opened Investigation By the Department of Telecommunications and Energy on its own Motion into Competitive Market Initiatives, D.T.E. 01-54, and has been analyzing various ways to stimulate the competitive market. In the comments it received in its NOI, the Department received a number of suggestions as to initiatives it could pursue to make competitive options open to consumers. It is methodically pursuing investigations into those options through a series of proceedings. Its Order in D.T.E. 01-54-A, provided competitive electric suppliers with enhanced access to customer information, and established a second phase of the proceeding to investigate implementation of internet based authorizations. The Department also issued its Order in Investigation into the Billing Services to be Provided by Electric Distribution Companies to Competitive Suppliers Serving Customers in their Service Territories, D.T.E. 01-28 Phase II, where it addressed a more equitable payment allocation for consolidated billing of distribution and supplier services.

The Department's direction to enhance consumer options has been very clear in all of its efforts to date.

Q. What has been the result of the Department's efforts to stimulate additional competitive choices for consumers to date?

A. According to the Data collected by the MA Division of Energy Resources and published on its website[1], electric customer migration has experienced a significant increase since the Department began its competitive initiatives. The number of competitive service customers has increased almost tenfold, from 2,463 in June 2001 to 20,283 in January 2002. Furthermore, the Cape Light Compact is making forward progress to begin its municipal aggregation efforts.

## IV. Natural Gas Competition in Massachusetts

Q. What is the current state of natural gas competition in Massachusetts?

A. Competition in the natural gas market in Massachusetts is alive and progressing. The competitive market in Massachusetts has been evolving since the early 1990s when retail competition started in earnest. As LDCs unbundled and made their tariffs more supplier friendly, the market continued to grow. According to Bay State's discovery response to AE 1-4, for 2001, 21 percent of its commerical and industrial ("C/I") customers and 61 percent of its C/I load have migrated to the competitive market. We believe the percentage of C/I load now served by competitive suppliers on Bay State's system is fairly representative of the percentage of C/I load served by competitive suppliers statewide. The residential side of the market is in an earlier stage of evolution, and very few residential customers have migrated. Until November 2000, the market was open only to commercial and industrial customers, other than the Bay State pilot. At that time, LDCs implemented Model Terms and Conditions for Service by Distribution Companies and Suppliers and opened up the competitive market to all consumers.

Although , most of the residential pilot customers on Bay State's system have been returned to utility provided merchant service, this should not be viewed as a long-term failure of the competitive natural gas market. As the Department works through competitive market initiatives in the electric industry, it can apply many of its findings to the gas industry. The Department is also scheduled to begin its end of transition period review of capacity assignment in the next few years.[2] It is not yet time to give up on the development of the competitive natural gas market.

[1] http://www.state.ma.us/doer/pub_info/migrate.htm#jan02

## V. Incentives

Q. How does this relate to Bay State's GCIM proposal?

A. The Department's goals for natural gas competition as listed above state that the Department "should rely on incentive regulation where a fully competitive market cannot exist, or does not yet exist." AllEnergy believes that the market is the best regulator of competitive services, and it is inappropriate to provide incentives to the local monopoly to perform competitive functions. To do so will will harm the development of a competitive market. It is AllEnergy's concern that if Bay State is allowed to implement a gas cost incentive mechanism, competition could be harmed on its system. While there is a competitive market available for most business customers, the residential market has not yet had the opportunity to develop. It would be premature to conclude that the competitive market cannot develop sufficiently to serve all customers, and therefore resort to incentive regulation for merchant service.

Q. How could the competitive market be harmed if Bay State is allowed to implement its incentive mechanism?

A. Under traditional unbundled rate regulation as implemented by the Department, LDCs remain indifferent as to whether their customers take LDC provided merchant service or service from a competitive supplier. However, once a utility is allowed to earn a profit on its merchant service, it views suppliers as competitors. When this relationship changes to one of competitors, it leaves the

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[2] DTE 98-32-B Notice of Inquiry into the Unbundling of all Natural Gas Local Distribution Companies , page 58-59 .

door open to market power abuses by the LDC. This is because the LDC becomes a supplier with enormous competitive advantage over all other suppliers with which it competes: it controls the essential distribution facility that all suppliers require and it "owns" or has acquired at no cost the vast majority of customers. The ability of a distribution company to use its monopoly position in the distribution function to obtain an unfair advantage in the competitive, merchant function was one of the reasons that the Department and other state commissions implemented affiliate rules. Investigation to Establish Standards of Conduct Governing the Relationship Between Natural Gas Local Distribution Companies and Their Competitive Affiliates and Governing the Relationship between Electric Companies and Their Competitive Affiliates, D.P.U. 96-44 (December 30, 1996). The Department needed to assure that an unregulated merchant business was not singularly advantaged by its affiliated regulated monopoly business, and that the monopoly did not subsidize the unregulated business.

As LDCs lose load to competitive suppliers, it limits their ability to earn profits on their GCIM. The LDC not only has no incentive to encourage customers to migrate to the competitive market under GCIM, it has a direct incentive to discourage migration and to try and get customers back to its sales service. This type of incentive could lead to efforts by the utility to attempt to block migration through more subtle means.

If an LDC is allowed to implement a GCIM and subsequently earns profits from the incentive program, the LDC becomes addicted to the incentive. It becomes very difficult for the LDC to explain diminishing incentive earnings in subsequent years to its parent or shareholders. Consequently, once an incentive is put in place, it could become very difficult to eliminate it.

According to data provided by Bay State, it is very likely that it could earn an incentive under their proposal. Bay State is already performing at the target level of its proposal. When compared to Bay State's historical CGA, a GCIM would only have saved customers approximately 0.09 percent off their gas costs as seen below in Table 1. Bay State is proposing to keep a large percentage of savings over index. In this case, it would have retained 50 percent of the savings, which would have given customers less than $100,000 in savings on an annualized basis. In my opinion, where Bay State is already performing at the target, a Gas Cost Incentive as proposed by Bay State is not warranted, nor would it necessarily produce significant savings for customers over Bay State's existing CGA.

**Table 1**

| Line No. | Reference | | | Pro-Forma GCIM Savings 11/1/99 - 12/31/01 ($000) |
|---|---|---|---|---|
| 1 | AE 1-7 | Term Deals | $ | 498 |
| 2 | AE 1-7 | Mid-Month | | (142) |
| 3 | AE 1-7 | Spot | | 17 |
| 4 | Sum 1-3 | Total | $ | 373 |
| 5 | L.4 / 26 mos. | Per Month | $ | 14 |
| 6 | L.5 * 12 mos. | Annualized | | 172 |
| 7 | AG 1-31, BSG 2000 Annual Rtn. Pg 43. | Total 2000 Gas Cost Revs | | 184,337 |
| 8 | | Pro-Forma savings if GCIM applied to CGAC | | 0.09% |

Q. Do you have other concerns regarding the structure of this incentive proposal?

A. Yes. In its Incentive Competition Order, D.P.U. 94-158 (1995) the Department established criteria to evaluate incentives. These criteria are listed earlier in my testimony. Bay State's proposal does not satisfy two of the seven criteria. These two criteria specify that

> "(2) incentive proposals should be designed to serve as a vehicle to a more competitive environment and to improve the provision of monopoly services", and

> "(5) incentive proposals should focus on comprehensive results. In general, broad-based proposals should satisfy this criterion more effectively than narrowly-targeted proposals."

Bay State's proposal is not a vehicle to a more competitive environment; rather, it is a vehicle for Bay State to participate in an existing competitive environment. Additionally, the GCIM will not necessarily improve the provision of monopoly services to customers, because volume risk remains with customers. Bay State's incentive mechanism allows Bay State to compete against suppliers with significantly less risk than suppliers have, and has the potential for more rewards than suppliers can obtain because all of Bay State's gas costs are recoverable from ratepayers. The risk/reward equation is significantly out of balance for Bay State vis-à-vis competitive suppliers. Under Bay State's GCIM, Bay State incurs price risk, but is immune from the volume risk faced by suppliers. Volume risk remains with customers.

Q. Please describe volume risk.

A. Volume risk occurs as customers use more or less gas than expected. If a customer uses more than expected, the supplier then has to buy the additional volumes at the current market price, which may be more or less than the customer's contract price that will be paid to the supplier. If a customer uses less than expected, the supplier must sell the difference, which could result in a gain or a loss. Most often customers are using more or less gas due to weather conditions. Since a large segment of the market is moving in the same direction with weather, it impacts demand, which impacts the price, frequently not in the supplier's favor.

Q. How is Bay State immune from volume risk?

A. Bay State is allowed to defer gas cost differences due to variations in customer usage through the reconciliation mechanism in the Cost of Gas Adjustment. They can then collect or return these under or over collections in the next CGA period. Customers assume the volume risk. This ability to reconcile volume differences eliminates gas cost related volume risk from the LDC's bottom line.

Q. How does that impact competition?

A. Under Bay State's GCIM proposal, Bay State is able to compete with a supplier's price, earn an incentive, but remain insulated from the volume risk that the supplier faces. This creates a tilted playing field where the incumbent monopoly has an advantage in that it does not have to consider volume risk in its purchasing strategies or in pricing its services. Bay State's GCIM proposal therefore fails the Department's criteria that incentive mechanisms should be designed to serve as a vehicle to the competitive market. It may in fact erect a barrier in Bay State's service territory.

Q. Please describe how Bay State's GCIM fails the Department's criteria that incentive mechanisms should be broad-based and focus on comprehensive results.

A. Bay State's GCIM only addresses the commodity portion of merchant service. It does not include capacity or non-domestic resources or administrative costs. Competitive suppliers, however, must recover capacity, commodity and administrative costs in the prices of their products. Additionally, consideration of only commodity costs could skew Bay State's capacity planning decisions to favor domestic capacity where Bay State feels it has the best chance of beating the commodity index.

The best gas cost incentive mechanism, if Bay State wants to earn a profit on merchant service, would be for Bay State to set up an unregulated affiliate to compete with other suppliers on an equal footing where every decision could affect the bottom line. This would allow Bay State to face all of the risks that competitive suppliers face. This is more in line with the Department's desire for broad-based incentive mechanisms.

Q. Bay State's testimony claims that its GCIMs have been implemented in other states. What is happening with them now?

A. In New York, the Public Service Commission has phased out all commodity based gas cost incentive mechanisms. The mechanisms that were in place on the National Fuel and KeySpan systems have been phased out in the last few years. According to the Deputy Director of the Gas Division of the NY PSC, New York policy has changed to focus more on capacity, as that is where it believes consumer savings lie.

Also in New York, New York State Electric and Gas is ending a multi-year incentive mechanism for residential customers, which includes incentives related to gas costs. It is a broad-based price cap. The plan does not end until September 2002, so current switching data will show the impact of the program. According to New York's most recently posted switching data,[3] and summarized in Exhibit AE-3, NYSEG has had a switch rate that is disproportionately low to the number of customers it serves as compared to other New York gas utilities, and it appears that its residential program is to blame. NYSEG has effectively squelched competition in that sector on its system. Furthermore, NYSEG is now trying to recover losses it experienced in the final year of that mechanism.

Many of the other GCIMs noted by Bay State were put in place in the mid-1990s. There was a movement toward this type of mechanism at that time. It is not clear if they are still in operation, or if universal choice is available in all of the states in which they have been implemented.

## VI. Use of Financial Instruments

Q. What is your position regarding the use of financial instruments by LDCs to lock in gas prices?

A. I do not oppose the use of financial instruments by LDCs as long as their use is limited in quantity and duration. Most importantly, a program utilizing financial instruments should be designed in such a way that it does not harm the competitive market. LDCs should also be required to include the costs of the financial instruments and administration in its merchant service price. My position is described in full in the joint comments of the Suppliers in the Department's NOI in D.T.E. 01-100. I have attached a copy of those comments here as Exhibit AE-4.

## VII. Conclusion

Q. Please summarize your position regarding Bay State's Gas Cost Incentive Mechanism proposal.

[3] New York's current switching data can be found at http://www.dps.state.ny.us/Gas_Migration.htm.

A. The Department should reject Bay State's GCIM proposal as potentially harmful to competition. Without incentives, Bay State has performed close to the proposed index target historically with its own CGA. Any limited savings customers might see would not justify the risk to competition. Instead, the Department should look at ways to enhance the competitive natural gas market in much the same way as it is in the electric market. Robust retail natural gas competition will provide the true savings to customers, savings that will include all aspects of providing gas merchant service, not just commodity.

Q. Does this conclude your testimony?

A. Yes, it does.